

**Draft of 3/10/05**

## **Pension and Benefit Case Study**

Crossroads is a city of 350,000 or so founded shortly after the Civil War on rolling hills along a riverbank at the edge of the Great Plains. Early growth as a river port and rail transport center, followed by expansion of the Interstate Highway System and a north-south and east-west intersection only 10 miles from downtown, have helped Crossroads become the major commercial center for the region. Today Crossroads boasts a branch of the State College system, a small liberal arts college, a variety of technical schools, and a school of nursing affiliated with a hospital founded a century ago by a religious order. Crossroads also has a municipal hospital founded over seventy years ago. The two hospitals and a variety of clinics provide more than adequate health care for Crossroadeans, as its citizens take pleasure in calling themselves. A large coal-fired electric plant, downwind and downstream from Crossroads, provides ample electric power for Crossroads and for export. Its comfortable size, picturesque location, generally stable economy, and quality health care services make Crossroads a place where people remain when they retire. Some of its citizens even moved there after retirement for just these reasons.

Crossroads historically has maintained high ratings from the rating agencies. Crossroads is conservative in going to the bond market, with new money general fund secured issues on the average of every other year (excluding refundings) and, of course, the annual cash flow borrowing just prior to fiscal year end. It has received many awards for the quality of its Comprehensive Annual Financial Report or “CAFR,” which it typically releases in late November, following issuance of the audit report by its independent audit firm on the fiscal year ending June 30, and files with the NRMSIRs, or central securities repositories through a state-of-the-art disclosure dissemination agent in late March, as required by its disclosure agreements with bondholders.

Quality of life is understandably important to Crossroadeans. A professional police and fire department, innovative public works department, good schools and libraries, and well-maintained riverside parklands sprinkled with both quiet meadows and ample public sports facilities (including a 27 hole municipal golf course!) have long satisfied Crossroadeans’ desire for “the good life.” Many of its retirees have also enjoyed a sense of economic security as a result of their generous railroad, municipal, and utility pensions. To out-of-state friends and relatives, Crossroadeans will on occasion admit to being somewhat spoiled.

In City Hall, however, a handful of senior municipal servants have become increasingly worried over the last few years. The growing retiree population, with incomes fixed, strongly resists any increase in taxes or fees. While Crossroads hasn't experienced a decline in employment, its college and technical school graduates increasingly find more challenging opportunities elsewhere. State government takes away more and returns less, giving each year's annual budget cycle greater potential for an unpleasant surprise. Sustaining, let alone expanding, the quality of public services and amenities has become more difficult each new fiscal year and deferral of facilities maintenance is quietly growing citywide.

Municipal labor negotiations have become more difficult as Crossroads, once ranked among the highest in combined compensation and benefits for its employees, gradually descends in the rankings while losing an increasing number of star employees. In recent years, on occasion, agreements have been reached more through increasing retirement benefits than wages. Typically, these benefit increases are retroactive. The burst of the dot-com bubble reduced state tax collections, increasing the State's tendency to take more and give back less.

Crossroads established a defined-benefit pension plan for its municipal workforce in the 1920s. The plan is administered by a Pension Board, with the framework contained in the City Charter. Of the nine board members, two are city officials serving in an ex-officio capacity, two represent unionized employees, one is elected by retirees, and two are appointees of the mayor from the local business community. The City's independent auditor also audits the pension system and assists the system in preparing its own CAFR. Contributions to the system are set by agreement between the City and the Pension Board. The actuary has used an assumed accrual rate of 8% as one of the many assumptions used in determining the future obligations of the system. Over the years, the Pension board has allocated annual cash earnings on system assets in excess of this 8% to pay a variety of additional benefits, including the cost of post retirement health care benefits.

The April 2000 market drop affected the investment portfolio of Crossroads pension system similarly to other managed investment portfolios. The market value of the securities in the pension system dropped 20% and actual cash earnings exceeding the 8% system assumed accrual rate suddenly vanished. Every other February, the pension system actuary releases a draft report to the pension system board containing a snapshot of the pension system as of the most recent fiscal year end, including a variety of statistics such as the ratio of system assets to system liabilities or "funded ratio," along with recommended adjustments to rate assumptions based upon actual experience. The funded ratio has declined in the

last two reports, with a slight decline for the report covering the period ending June 30, 2000 and a more precipitous drop to 80% for the period ending June 30, 2002. The report for the period ending June 30, 2004 is delayed, with the actuary still completing final review.

Crossroads hopes to go to market in the near future with a new-money offering to expand its public libraries. In addition, several outstanding bond issues may be current-refunded, achieving additional savings. Of course the annual mid-summer cash flow borrowing is also planned.

**Questions for Discussion:**

1) What matters, if any, in the narrative should be considered in connection with preparing the official statements for the offerings? Assuming Crossroads follows a disclosure format typical to that used by many entities in general obligation financings, what topics, if any, are affected by the matters in the narrative? What questions should be asked?

2) Excerpts from Crossroads' CAFR are typically attached as an exhibit to Crossroads offering documents and a consent letter is received from the independent auditor. What actions, if any, should be taken with respect to such excerpts?

3) If Crossroads were not going to market, what disclosure questions, if any, would the above fact pattern present?

4) What questions, if any, may Crossroads want to ask of:

- a) Its financial advisor;
- b) Its disclosure counsel;
- c) Its bond counsel;
- d) Its auditor;
- e) Its underwriters?